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Towards a durable solution to the debt problems of developing countries

Report of the Secretary-General

Summary

The present report, submitted pursuant to General Assembly resolution 62/186, contains a review of recent developments in the external debt of developing countries and describes progress in debt relief initiatives and in Paris Club rescheduling. It shows that the average debt ratios of developing countries continued to improve during 2007, but that there were substantial differences between countries. Several low-income countries were running current account deficits and facing a deterioration in their external situation. The report also examines the interaction between external and domestic public debt sustainability, and reviews progress in debt management capacity-building efforts in developing countries.

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I. Introduction

1. The present report is submitted to the General Assembly in accordance with paragraph 29 of Assembly resolution 62/186. It includes a comprehensive and substantive analysis of the external debt situation and debt-servicing problems of developing countries and a review of debt management capacity-building efforts, in particular those of the United Nations system. It sets out to elucidate new developments and key trends in external debt and related areas of development finance and to provide a basis for deliberation of related policy issues.

II. Recent trends

2. During 2007, the total external debt of developing and transition economies increased by $373 billion and, by the end of the year, reached $3,357 billion (see annex). That increase in total external debt was more than compensated for by accumulation of international reserves, which grew by over $1,000 billion from 2006, reaching $3,719 billion at the end of 2007. As most international reserves are held in debt instruments issued by the developed economies, by 2008 developing and transition economies, as a group, had no net external debt, but held net external debt assets of about $350 billion.

3. The growth rate of international reserves also outpaced that of short-term debt. At the end of 2007 all developing regions had reserves-to-short-term-debt ratios that were above 250 per cent (the average was 475 per cent, ranging from 278 per cent in Eastern Europe and Central Asia and 1,286 per cent in South Asia). However, there are large differences between countries in the accumulation of international reserves. Four countries (Brazil, China, India and the Russian Federation) hold two thirds of all international reserves held by developing and transition economies and several developing countries have international reserves that are well below the level of their short-term external debt.

4. As gross national product (GNP) grew faster than debt, the external debt-to-GNP ratio of developing and transition economies dropped to 24.4 per cent, two points lower than its 2006 value. Over the same period, the debt-to-export and the debt-service-to-export ratios decreased by three percentage points. While the overall decline in debt ratios was similar to that of 2005-2006, the regional composition has changed. The 2005-2006 reduction was driven by above-average decreases in the external debt-to-GNP ratio of sub-Saharan Africa, Latin America and the Middle East and North Africa and increases in the external debt-to-GNP ratio in Eastern Europe and Central Asia. Over 2006-2007, debt ratios decreased in all regions by between one and two percentage points and sub-Saharan Africa was the region with the smallest decrease in its debt-to-GNP ratio (0.8 of a percentage point). That comparatively weak improvement contrasts with a decade of continuous debt reduction that brought Africa's external debt from 70 per cent of GNP in the second half of the 1990s to 25 per cent by 2007.

5. There are, however, large differences between countries. At the end of 2006, the country at the 90th percentile of the distribution had a debt-to-GNP ratio of 102 per cent and that at the 10th percentile of the distribution had a debt-to-GNP

ratio of 17 per cent.[1] Moreover, these figures are weighted averages, which are heavily influenced by the behaviour of the largest developing and transition economies (the five largest developing and transition economies accounting for approximately 50 per cent of the total GNP of this group of countries). The simple average of the external debt-to-GNP ratio of these countries is about 55 per cent, twice as large as the weighted average reported in the annex.

6. Thus, while the cross-country average shows a net reduction in the external debt of developing and transition economies, looking beyond averages shows that this improvement is driven in part by the performance of a few large countries and by that of a few countries that in the mid-1990s had extremely high debt ratios. Moreover, improvements in debt ratios are driven in part by favourable external conditions, which play an important role in the evolution of the external debt of developing countries. An economic crisis in the developed world and a jump in risk aversion of international investors could reverse the current positive trend. In fact, there are already signs that this may happen. During 2007, two thirds of developing countries suffered a deterioration in their current account balance, 50 per cent of developing countries closed the year with a current account deficit greater than 5 per cent of GNP and about a quarter of developing countries ran current account deficits greater than 10 per cent of GNP.[2] The divergence in the behaviour of the current account and external debt situation of developing countries is occasioned in part by increases in commodity and food prices, which have benefited commodity exporters but caused problems to commodity importers, especially low-income oil and food importers. There are indications that private flows to developing countries slowed down in late 2007 and early 2008. If that trend continues, some developing countries may face problems in financing their deficits.

7. Thanks to debt relief under the Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI), sub-Saharan Africa was the only region that saw a reduction in the nominal value of its debt stock (from $230 billion in 1995-1998 to $194 billion in 2007). However, data on the face value of debt relief can give a misleading impression on the actual change in the value of the external debt of developing countries. Estimating the "real" reduction in debt brought about by debt relief is a complicated exercise that requires several assumptions, but there is some evidence that the real reduction in debt brought about by debt relief initiatives over the period 1989-2003 is about 50 per cent lower than the face value of debt relief delivered over the same period. Another important issue is that of additionality. The Monterrey Consensus[3] stated that debt relief should be fully financed through additional resources, but recent research shows that there is no clear evidence that debt relief has been fully additional.[1]

8. Another significant pattern relates to debt composition. In the late 1990s, 48 per cent of the total long-term external debt of developing countries was owed to private creditors (the remaining 52 per cent was owed to official, multilateral and bilateral creditors); by 2007, that share had reached 75 per cent. Meanwhile, the

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[1] See United Nations Conference on Trade and Development, *Trade and Development Report 2008*.

[2] World Bank, *Global Development Finance 2008* (Washington, D.C., 2008).

[3] *Report of the International Conference on Financing for Development, Monterrey, Mexico, 18-22 March 2002* (United Nations publication, Sales No. E.02.II.A.7), chap. I, resolution 1, annex.

share of total long-term external debt contracted by private borrowers grew from 20 per cent to 48 per cent and the share of public and publicly guaranteed debt went from 80 to 52 per cent. Eastern Europe and Central Asia is the region with the largest share of long-term external debt owed to private creditors (92 per cent), as well as debt owed by private borrowers (71 per cent). Sub-Saharan Africa lies at the opposite end of the spectrum, with 37 and 14 per cent, respectively. Over the last five years, several middle-income developing countries pre-paid their debts with bilateral and multilateral official creditors. As a consequence, net official lending declined by $70 billion in 2006 and by $4 billion in 2007. Over the period 2002-2007, net lending by the World Bank group increased by $800 million (the balance of a $4.4 billion decrease in lending by the International Bank for Reconstruction and Development and a $5.2 billion increase in International Development Association (IDA) lending).[2]

9. While overall debt levels were declining, in 2007 net private inflows to developing countries surpassed $1 trillion (a $270 million increase from 2006). About 60 per cent of those inflows consisted of equity flows and the remaining 40 per cent of debt flows, with bank loans accounting for approximately three quarters of private long-term debt flows (down from 87 per cent in 2006).[2] International bond issuances by developing countries, which had slowed down in 2006, increased again in 2007. The overall increase masked a reduction of issuance by Latin American and Caribbean countries, which was more than compensated for by an increase in issuance by Eastern European and Central Asian countries (a region that accounted for approximately 50 per cent of international bonds issued by developing countries and countries with economies in transition in 2007). While an increasing number of developing countries are issuing bonds in the international capital market, about two thirds of them have never issued such bonds.

10. The reduction in external public debt is due in part to budget surpluses and a reduction in total public debt of developing countries, but is also brought about by a debt management strategy aimed at retiring external debt and replacing it with domestically issued debt. In 1994, about 30 per cent of developing countries' total public debt was issued domestically; by 2005 the share of domestic debt had increased to 40 per cent.[4] While more recent data for all developing countries are not available, there is some evidence that this trend continued over the period 2005-2007, especially in large emerging market countries. These changes in the composition of external and public debt have important implications for debt sustainability because different types of debt lead to different vulnerabilities (see A/62/151).

11. Although the switch from external to domestic borrowing is part of a debt management decision of developing countries, external factors played a role and such a switch would have been more difficult under different global conditions. Favourable external conditions helped developing countries to strengthen their domestic debt market for at least two reasons. Firstly, current account surpluses reduced developing countries' need for external resources. Secondly, low interest rates and abundant global liquidity led several investors to chase returns in new markets and increase their holding of local instruments issued by developing

[4] U. Panizza, "Domestic and external public debt in developing countries", UNCTAD Discussion Paper 188 (2008).

countries.[5] It is not clear if that trend will continue in the current climate of tighter liquidity.

12. The most significant financial event that occurred over the last 12 months was the turmoil linked to the sub-prime mortgage crisis in the United States of America. That crisis has proved to be more profound and persistent than many had expected and its consequences are having a negative effect on growth in the developed economies. The developing world is still growing at a robust pace and there has been no financial contagion from the developed to the developing world.[6] However, the downside risk has increased substantially: if the liquidity crisis were to spill over to the market for emerging market debt, developing countries could face a sudden increase in their financing costs. Given the developing countries' stronger external position, the consequences of such an increase in financing costs would not be as harsh as those of the financial crises of the second half of the 1990s, but it could still lead to problems, especially in developing countries that are running large current account deficits. In this sense, the most vulnerable countries are non-oil exporters in Eastern Europe and Central Asia, but vulnerabilities are not limited to that region, as the majority of developing countries and countries with economies in transition are still running current account deficits.

13. The sub-prime mortgage market meltdown exposed the fragility of the modern financial sector. Instead of reducing risk, the complex financial instruments developed in recent years have ended up spreading the impact of risky investments across continents, institutions and markets. The crisis also highlighted problems linked to the lack of transparency of derivative instruments and showed that credit rating agencies, which should solve information problems and increase transparency, did not play the role they were supposed to play.[7] These events should give developing countries pause to reflect on what path of financial sector development and what level of sophistication is most suited to their level of development.

III. Debt relief and official development assistance

14. Since the start of 2007, progress under the enhanced HIPC Initiative has continued at a slower pace. The average amount of time for countries to pass from the decision to the completion point has been increasing and is now close to four years (as opposed to two years for countries that participated in the original Initiative). As at 31 May 2008, just over half of the 41 eligible countries (23) have reached the completion point, with 10 countries at the interim stage between decision and completion points and 8 countries at the pre-decision point. From January 2007 to 31 May 2008, three countries — Afghanistan, the Central African Republic and Liberia — reached the decision point and two countries — Sao Tome and Principe and the Gambia — reached their completion points. Several countries

[5] Foreign investors' holdings of locally issued instruments are supposed to be classified as external debt and not domestic debt, but this is rarely done (see A/62/151).

[6] In the aftermath of the crisis, the increase in sovereign spreads in emerging markets was about one third the increase in the spreads of high-yield corporate bonds issued in the United States.

[7] A/61/152, paras. 22-27. The UNCTAD study on recent developments on global financial markets (TD/B/54/CRP.2) provided an early analysis of the crisis.

that have not yet reached the decision point are conflict-affected countries where the political and/or security situation has hindered progress.

15. Upon reaching the completion point, all countries benefited from 100 per cent cancellation of their outstanding multilateral debt claims under the MDRI to the International Monetary Fund, IDA, African Development Fund and, most recently the Inter-American Development Bank. While the majority of HIPCs are covered by these regional financial institutions, not all will benefit equally because the Asian Development Bank is currently not participating in the MDRI.

16. There is an asymmetry in the MDRI. By granting 100 per cent multilateral debt cancellation to highly indebted poor countries that reached the completion point under the HIPC Initiative but not granting any debt relief to moderately indebted poor countries, MDRI does not reward low-income countries that manage to maintain low levels of debt. This is not to say that a highly indebted country should not benefit from the MDRI, but that all low-income countries should benefit from the Initiative and that participation in it should not be contingent on being highly indebted.

17. By December 2006, the HIPC Initiative and the MDRI had reduced the net present value of debt in post-decision point countries by $96 billion and the Initiatives were important in reducing the debt ratios of the participating countries. For example, median debt service per capita declined from $9.2 in 2000 to $6 in 2005. The average debt service-to-export ratio went from 18 per cent at the decision point to 5.6 per cent in 2006 and is expected to reach 3.3 per cent in 2011.[8] Lower debt service allowed heavily indebted poor counties to increase social expenditure in a manner consistent with national priorities and internationally agreed development goals, including the Millennium Development Goals. There are, however, large cross-country differences and the share of debt service reduction as a share of GNP ranges between 0.3 per cent in Zambia and 1.8 per cent in Guyana. Moreover, several low- and middle-income countries are not included in current debt relief initiatives but face serious debt sustainability problems and experience severe constraints in mobilizing the resources necessary to achieve the internationally agreed development goals. Such countries should be included in future debt relief initiatives.

18. Even though debt relief provided under the two initiatives improved the debt ratios of the receiving countries, the 2007 HIPC and MDRI status of implementation report[8] suggests that more than half of the post-completion point countries are still considered to have either a moderate or a high risk of debt distress and only 10 out of 22 post-completion point countries have graduated to the low-risk category. This indicates that the provision of debt relief alone will not ensure that completion point countries will attain sustainable levels of debt in the long-term. Those countries still face several challenges, including increasing export diversification, financing poverty reduction strategies, navigating external shocks, improving resource utilization and adopting effective debt management practices.

19. The United Nations Conference on Trade and Development (UNCTAD) continued to provide support to debtor countries in preparing for their negotiations

[8] International Development Association and International Monetary Fund, *Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI): Status of Implementation* (Washington, D.C., 2007).

on the rescheduling or restructuring of bilateral official debt in the framework of the Paris Club. Since the last report, four countries rescheduled their debt with Paris Club creditors, and there was some activity in prepayment and regularizing relations with those creditors. In December 2007, the Gambia reached completion point and Paris Club creditors cancelled its entire pre-cut-off date debt as well as 86 per cent of the debt stock accumulated between 1986 and 1999. Paris Club creditors met to consider debt relief for Guinea in January 2008. They agreed to reschedule payments on pre-cut-off date debt falling due between January 2008 and December 2010 under Cologne terms and to defer until 2011 the repayment of accumulated arrears on short-term and post-cut-off date debts. In April 2008, Liberia rescheduled its Paris Club debt following the attainment of the decision point under the HIPC Initiative. In June 2008, Togo rescheduled its Paris Club debt under Naples terms and is expected to reach the decision point under the HIPC Initiative by the end of 2008.

20. In July 2007, Paris Club creditors accepted Gabon's offer to prepay at par its non-official development assistance (ODA) debt rescheduled at the 1994, 1995, 2000 and 2004 meetings. The operation was concluded in early 2008. In October 2007, Paris Club creditors accepted Jordan's prepayment offer, which was implemented in the first half of 2008. In December 2007, Angola announced that it would clear all its outstanding arrears and thus regularize its relations with Paris Club creditors. That action paved the way for Paris Club creditors to resume granting export credits to Angola.

21. In addition to debt relief initiatives, the provision of ODA plays an important role in financing development and in pursuing the Millennium Development Goals. Repeated calls have been made for donors to increase ODA contributions to 0.7 per cent of the gross national income (GNI) target, most recently reaffirmed at the Millennium Summit. Success of the Millennium Development Goals hinges on the provision of adequate financing to achieve those goals in particular, though not to the exclusion of other development goals.

22. In 2007, total ODA from members of the Development Assistance Committee (DAC) amounted to $103.7 billion, marking an 8.4 per cent decline of ODA in real terms. Debt relief accounted for almost two thirds of the surge of ODA in 2005, when total aggregate ODA reached a peak ($107.1 billion), amounting to around 30 per cent of all ODA provided in 2005-2006, and the current decline in total ODA is due to the conclusion of exceptionally large Paris Club debt relief operations granted to Iraq and Nigeria in 2005. While total net ODA, excluding debt relief, increased by 2.4 per cent, the ODA-to-GNI ratio amounted to 0.28 per cent in 2007 — below the level reached in the early 1990s — and below the 0.35 target set for 2010. According to estimates by the Organization for Economic Cooperation and Development, most donors are not on track to meet the commitments set for 2010.[9]

IV. Debt sustainability

23. There are two standard frameworks for assessing debt sustainability in developing countries. The first was developed by IMF and focuses on middle-income countries. The second was jointly developed by IMF and the World Bank

[9] See http://www.oecd.org/document/8/0,3343,en_2649_201185_40381960_1_1_1_1,00.html.

and focuses on low-income countries. The frameworks start by formulating a baseline scenario based on long- and medium-term projections of the evolution of policies and macroeconomic variables, which are used to evaluate the sustainability of debt ratios. The second step consists of stress-testing the model by using different assumptions on the behaviour of policy variables, contingent liabilities, external factors and macroeconomic developments to establish an upper limit for the future evolution of debt. The probability distribution of the projected evolution of the debt ratio is then used like an early warning system, which triggers policy advice to countries that are on an unsustainable path.

24. The main difference between the two frameworks relates to the definition of debt thresholds. For middle-income countries, IMF suggests that the probability of a debt "correction" increases significantly when external debt becomes higher than 40 per cent of GNP, but it does not establish an explicit threshold above which debt is deemed to be unsustainable. Such thresholds are instead a crucial component of the debt sustainability framework for low-income countries and are also used to guide grant allocation by IDA and other multilateral development banks. The debt sustainability framework for low-income countries compares long- and medium-term projections of the evolution of various debt ratios with debt burden thresholds based on the quality of policies as measured by the World Bank's Country Policy and Institutional Assessment (CPIA). Based on that comparison, countries are then classified into four groups: (a) low risk; (b) moderate risk; (c) high risk; and (d) in debt distress.[10]

25. The use of the CPIA as the sole criterion for determining debt thresholds has been the object of several criticisms. Historical series for the CPIA index are not publicly disclosed (only data for IDA countries starting from 2005 are disclosed). As a consequence, all analyses that link debt sustainability to the CPIA have been conducted by World Bank/IMF staff and external researchers have not been able to test the robustness of the links between the two variables. It is also questionable whether the quantitative impact of the CPIA on the probability of debt distress is large enough to formulate debt thresholds based on it alone. Moreover, it is not clear whether the CPIA is indeed a measure of policies or just a predictor of a debt crisis. While it may be reasonable to include the CPIA as one of the criteria used to define debt thresholds, it is harder to justify an approach that uses this variable as the only criterion.

26. Debt sustainability exercises for developing countries have traditionally concentrated on external debt, but debt crises since the 1990s have been characterized by either the presence of massive private external debt or the accumulation of a large domestic public debt. Thus discussions of debt sustainability focus on different definitions of debt. Some policymakers take into consideration external debt sustainability and the associated external transfer problem. Others concentrate on public debt sustainability and the associated budgetary problem. Yet others argue that there is no sustainability problem

[10] Countries are classified as low risk if all debt indicators are below the debt burden threshold and will remain below that threshold even if they suffer a large negative shock. Countries are classified as moderate risk if debt indicators are below the debt burden threshold but the country could breach the threshold in case of a negative shock. Countries are classified as high risk if the baseline projections indicate that the country will breach the threshold. Countries are classified as in debt distress if their debt ratios are in breach of the thresholds.

associated with the presence of external private debt and so they are concerned only with external public debt.

A. External sustainability and public debt sustainability

27. As most external debt of developing countries is denominated in a foreign currency, their net foreign debt has to be repaid in terms of internationally tradable goods and services.[11] This suggests that debt sustainability cannot be analysed without considering the use of the borrowed funds. Foreign borrowing used to finance a consumption boom is likely to be unsustainable. However, there are conditions under which even debt used to finance investment projects can be unsustainable. This may happen if the debt is used to finance an investment project that has a return that is lower than the interest rate charged on the debt, but also if the debt is used to finance an investment project that has a high private or social return but that does not have a direct or indirect effect on a country's ability to increase its foreign exchange earnings. It is in this sense that proper debt management, designed in a way to match debt structure with the project's flows of funds, plays a crucial role in guaranteeing debt sustainability. Another important consideration is that the current account surplus necessary for repaying a country's external debt on a net basis often requires a depreciation of the real exchange rate. Any evaluation of external sustainability thus requires a careful analysis of the behaviour of the real exchange rate.

28. Public debt (or fiscal) sustainability deals explicitly with the government budget constraint. In this case, the focus is not the external transfer problem but the internal transfer problem linked to the Government's ability to raise enough tax revenues to service the public debt. Clearly, in the presence of external public debt, the Government will have both an internal transfer problem (collecting taxes revenues) and an external transfer problem (converting the tax revenues into foreign currency).

29. There is a vast literature aimed at developing formal tests of fiscal sustainability, but most of them were formulated for the developed economies and they are not applicable to developing countries for which there are limited historical data. Practitioners thus often evaluate fiscal sustainability using indicators that are not well-grounded in economic theory. The most commonly used sustainability indicator is based on an equation that shows that the debt-to-GNP ratio remains stable if the primary budget deficit (i.e. the budget deficit net of interest payments) is equal to the stock of debt multiplied by the difference between the interest rate of the public debt and the economy's growth rate. Even though it is simple and intuitive, this approach to fiscal sustainability has several problems.

30. The first problem is that it makes it possible to study the conditions for stabilizing a given debt-to-GNP ratio, but it does not say anything about the optimality of that particular ratio. In fact, there are several good reasons why a country may need to run a deficit and increase its debt or run a surplus and decrease its debt. The second problem is that analyses based on the above equation assume

[11] This is also true when external debt is denominated in a country's own currency, but countries that issue the currency in which their debt is denominated can debase their debt by printing money.

implicitly that its components are exogenous with respect to each other. However, the Government cannot change its primary surplus and simply assume that GNP growth and the real interest rate will remain unchanged. Moreover, deficits incurred to finance investment are likely to have a different impact on long-term growth with respect to deficits incurred to finance current expenditure. It is possible that a reduction in public investment that improves the Government's current cash flow can lead to a deterioration in long-term solvency. This problem cannot be easily addressed by eliminating investment from fiscal targets because not all types of public investment project have the potential to improve long-term solvency. However, research has shown that countries that are well able to conduct ex ante evaluation of investment projects are able to select projects that may improve solvency over the long run. When possible, debt sustainability analysis needs to be incorporated into an asset-liability management approach. Borrowing that increases the value of a country's stock of assets is more likely to be sustainable than borrowing used to finance current expenditures or poorly designed projects.

31. A third problem is that even the simple indicator described above becomes complicated when one recognizes that developing countries often have limited capacity to raise taxes (because of a large informal sector), have a volatile revenue base, are subject to large external shocks that increase the volatility of GNP growth and debt service and are characterized by a complicated debt structure that makes the estimations of an "average" interest rate almost impossible. In fact, while fiscal sustainability exercises are usually centred on the analysis of the budget deficit, there is evidence that the reported deficit explains a small share of the variation of the debt-to-GNP ratio in developing countries.[12] This reinforces the need to pay more attention to contingent liabilities and balance sheet effects associated with debt structure.

B. Interactions between external and public debt sustainability

32. The most important interaction between fiscal and external sustainability relates to the behaviour of the exchange rate. This interaction introduces an unpleasant trade-off. On the one hand, a real devaluation might be a necessary condition for restoring external sustainability. On the other, since the external debt of developing countries tends to be in foreign currency, a large devaluation can lead to a jump in the debt-to-GNP ratio. A currency appreciation can thus have both a positive effect on public debt sustainability and a negative effect on external sustainability. This is not a problem for countries that can borrow abroad in their own currency. In this case, a depreciation of the real exchange rate can have a positive effect on both public debt and external sustainability (as long as the depreciation does not lead to a complete loss of trust in the currency and thus generate an inordinate increase in interest rates). This is why several countries are switching from external to domestic borrowing, even if the latter may imply a higher ex ante interest rate. However, a policy aimed at replacing external debt with domestic debt can reduce the exchange rate-induced trade-off but may entail others

[12] More than 90 per cent of this variation is explained by external shocks and valuation effects linked to debt composition (see C. Campos, D. Jaimovich and U. Panizza, "The unexplained part of public debt", *Emerging Markets Review*, vol. 7, No. 3 (2006), pp. 228-243.

(it can, for instance, lead to a maturity mismatch). Debt managers need to choose the optimal debt structure by carefully evaluating these dynamics.

33. These interactions between external and fiscal sustainability point to the fact that domestic debt should be mainstreamed into debt sustainability exercises. Currently, this is not a common practice for at least two reasons. The first reason relates to the fact that it is hard to find data on the level and composition of domestic debt. The second reason relates to the fact that different types of debt occasion different vulnerabilities and cannot be added up to form a single debt ratio. Data problems could be solved if there were the political will to do so. In fact, the League of Nations used to collect detailed data on the amount and composition of domestic public debt for both developed and developing economies and the United Nations continued to collect and publish such data until the early 1980s.[13] Aggregation problems could be treated by building a debt ratio that gives different weights to different types of debt (see A/62/151).

34. This discussion points to the fact that evaluating debt (both public and external) sustainability is more art than science. There are no simple indicators of sustainability and any evaluation of a country's ability to meet its future obligations needs to be country-specific and based on a careful analysis of several variables, including expectations on the future behaviour of a country's assets and liabilities. The fact that most shocks to the debt-to-GNP ratio depend on debt composition suggests that effective debt management can be as important as fiscal policy.

V. Review of public debt management capacity-building efforts in the United Nations and beyond

35. International and regional institutions that are active in assisting developing countries build their capacity in debt management include UNCTAD, the Commonwealth Secretariat, IMF, the Macroeconomic and Financial management Institute of Eastern and Southern Africa (MEFMI), Pôle-Dette, the West African Institute for Financial and Economic Management (WAIFEM) and the United Nations Institute for Training and Research (UNITAR).

36. The assistance provided by these agencies includes support to countries in facilitating their day-to-day operations (i.e. recording and administration of debt transactions and maintenance of a comprehensive debt database); support in debt portfolio, risk and debt sustainability analysis; and advice in debt strategy formulation and in debt restructuring. Of key importance is building the institutional, human and technical capacity of developing countries to manage their debt more effectively.

37. In line with the capacity-building pyramid concept introduced by UNCTAD in 2001 and since embraced by many other institutions, technical assistance in debt management must take a comprehensive approach. Debt strategy formulation is dependent on debt analysis, which is in turn dependent on the availability of statistics and reliable debt information. Capacity-building, therefore, must take

[13] C. Reinhart and K. Rogoff, "The forgotten history of domestic debt", NBER Working Paper No. 13946 (Cambridge, MA, National Bureau of Economic Research, 2008).

place at all of the different levels and no single institution can adequately provide support in all areas.

38. In order to cover all capacity-building needs, technical assistance providers concentrate on giving support according to their comparative advantage in the various debt management areas. The UNCTAD Debt Management and Financial Analysis System (DMFAS) Programme and the Commonwealth Secretariat, for example, provide support on "downstream" activities, including the maintenance of debt databases, debt data validation, day-to-day debt transactions, debt statistics and basic debt analysis. Consequently assistance includes the implementation of a debt management software, related training and ongoing support. The World Bank and IMF, on the other hand, concentrate their assistance on more "upstream" functions, including comprehensive need assessments, advanced debt analysis, debt sustainability, debt relief and debt strategies (within the larger macroeconomic framework). In the same context, the HIPC Capacity-Building Programme implemented by Debt Relief International (DRI) and four regional organizations (the Bank of Central African States/Central Bank of West African States Pôle-Dette, MEFMI, WAIFEM and the Centre for Latin American Monetary Studies (CEMLA)) builds capacity to design and implement debt strategies and analyse debt sustainability. The United States Treasury provides institutional support for improving debt management. UNITAR provides online training support in certain aspects of debt management, including legal training. The International Organization of Supreme Audit Institutions (INTOSAI) organizes workshops on debt management for auditors at the national and international levels. The regional organizations support countries in both upstream and downstream activities, in cooperation with the other providers, at the local and regional levels.

39. Collaboration and agreement on best practices by the different providers is essential. Collaborative efforts undertaken by all technical assistance providers in debt management capacity-building aim to ensure that support provided by one provider builds on the support of another and that best practices are shared. A number of international organizations make up the Inter-Agency Task Force on Finance Statistics, for example, which agrees on best international practices in statistical reporting. A product of the Task Force has been the External Debt Guide, which provides recommendations on debt reporting. In order to further facilitate the application of such best practices and agreed standards, capacity-building tools such as the DMFAS software include a classification and coding system that allows countries to produce reports according to the Guide's recommendations.

40. Examples of collaboration between the different institutions also include the organization of joint capacity-building workshops and seminars at the country or regional level. UNCTAD regularly co-organizes workshops with regional organizations such as MEFMI and Pôle-Dette in areas such as creation of debt databases, data validation and debt reporting. It also participates actively in or co-organizes IMF workshops in statistics or works with INTOSAI on debt data validation and quality control.

41. A number of tools have been developed over the years to facilitate the capacity-building process. These include the UNCTAD DMFAS software and the Commonwealth Secretariat Debt Recording and Management System (CS-DRMS) software. The majority of developing countries currently rely on either the DMFAS or CS-DRMS software for the management of their debt information, whether this

be external or domestic, public or private. The software also includes the World Bank Debt Sustainability Model (DSM+) as part of a partnership agreement between the three organizations. In 2007-2008, 56 countries were actively using the DMFAS system and some 50 countries CS-DRMS.

42. Additional tools for conducting debt analysis and strategy are currently being developed by the World Bank and IMF, with the active participation of other providers of technical assistance. These new tools include the Medium-Term Debt Strategy Programme, which aims at strengthening capacity in countries having benefited from HIPC and MDRI debt relief, as well as a new Debt Management Performance Assessment Tool, a methodology aimed at assessing performance of government debt management functions.

VI. Policy conclusions

43. Until recently, the standard view in most development and academic circles was that access to external resources was a necessary, if not sufficient, condition for igniting growth in poor countries. That view, which is consistent with modern neo-classic economic theory and traditional development finance strategies, is the main intellectual foundation of the Monterrey Consensus. However, empirical evidence has not been kind to this view. Over the past few years, several developing countries have been growing rapidly while running large current account surpluses and paying off their external debts.

44. This does not mean that access to external resources cannot play a positive role in economic development, but rather that it is not necessary for all countries or at all times. Two key challenges for a policy agenda on external debt are to identify which countries can benefit most from external resources and to implement debt management strategies that minimize the risk of a debt crisis. The ability to repay (the concept at the core of standard debt sustainability analysis) and the need for external resources are different concepts. There are countries that face an unsustainable debt situation and need more resources and there are others that do not have problems sustaining a higher level of debt, but are in a situation in which a net flow of external resources could have deleterious macroeconomic effects and a negative impact on economic and social development. Further revision of the Debt Sustainability Framework in Low-Income Countries should aim at identifying how the financing needs of these different groups of countries can best be addressed.

45. Domestic policies aimed at ensuring external debt sustainability should complement macro-level debt sustainability analysis with a careful evaluation of the sustainability of each project. Before borrowing abroad on commercial terms, a country should evaluate a project by ensuring that its social return is higher than the cost of funds, that it will generate the foreign currency necessary to service the debt and that the resource flow matches the payment schedule of the debt contract. In low-income countries some high-return projects may not satisfy the second and third requirements, so such projects should be financed with grants and concessional loans. An example of the need for more aid is the current food crisis. In order to mitigate the negative impact of higher food prices on the poorest segments of the population, some developing countries need to scale-up food subsidies, which will have a negative impact on fiscal sustainability and (for net food importers) external sustainability.

46. Given that an increasing share of borrowing by emerging market countries originates within the private sector, these countries need to carefully supervise the activities of private agents and ensure that private borrowing does not generate excessive vulnerabilities in the balance sheets of domestic banks and corporations. Countries that issue sovereign debt in the international capital market and have a well-functioning domestic financial system should adopt a debt strategy incorporated into the framework of a proper asset-liability management approach. Debt managers should set targets in such a framework in terms of both the cost and the risk of the various debt instruments they issue and carefully evaluate the costs and benefits of issuing contingent and equity-like debt instruments.

47. Assessing sustainability also requires accurate and timely information on debt level and composition and all developing countries need a well-functioning mechanism for collecting and reporting data on sovereign debt. While most developing countries collect data on external debt, they rarely have the ability to consolidate information on the domestic and external debt of various public entities.

48. Finally, the Debt Sustainability Framework is based on the primacy of debt servicing and does not explicitly include an evaluation of the needs that must be fulfilled in order to achieve the Millennium Development Goals. As stated in the Secretary-General's follow-up report to the Millennium Summit, we should redefine debt sustainability as the level of debt that allows a country to achieve the Millennium Development Goals and reach 2015 without an increase in debt ratios (A/59/2005, para. 54). Other considerations have also been cited in United Nations forums, such as the Commission on Human Rights, which called for the drafting of guidelines for external debt relief programmes to ensure that the need to service foreign debt did not undermine obligations for the realization of fundamental economic, social and cultural rights. Meanwhile, the growing legal and political interest in concepts such as odious debt and responsible lending adds yet another dimension to the concept of debt sustainability and its applicability as currently defined.

49. Rather than being additional, debt relief delivered over the past few years appears to have crowded out non-debt relief aid flows. This suggests that design and evaluation of debt relief initiatives should include an explicit measure of the additionality of debt relief. Donors should also recognize that past debt relief efforts have been somewhat unfair to countries with large developmental needs but low debt levels. Donors should ensure that low-income countries with low levels of debt are appropriately rewarded for maintaining prudent macroeconomic policies by including these countries in the MDRI.

50. Financial and debt crises in countries with market access are often driven by liquidity problems and not by solvency problems. In middle-income countries, the main obstacle to debt sustainability is the precarious access to the international capital market. Policymakers in the advanced economies should acknowledge that shocks that may lead to a liquidity crisis in the developing world often depend on external factors that originate in policy decisions made by the advanced economies. These externalities call for more international coordination in policymaking. Innovative debt instruments such as GDP-indexed bonds and local currency debt instruments could make developing countries more resilient to external shocks. However, countries may need the help of the international community in order to issue such instruments.

51. Until recently, research and policy focused on external debt just because there were no data on domestic debt, but collecting and disseminating data on the composition of total public debt is not an impossible task. Because vulnerabilities cannot be identified without prompt and reliable data on the composition of both external debt and domestic public debt, the international community should promote efforts aimed at producing and disseminating such data. Economists and practitioners are now converging towards the idea that debt crises are related to both debt levels and debt composition and that there are important interactions between domestic public debt and external debt. As a consequence, the distinction between external and domestic debt is becoming less relevant and the international dialogue should be refocused from external debt to external and public debt.

52. Donors should support programmes designed to improve the debt management and data collection capacity of developing countries and ensure that all countries report comparable data and cover domestic public debt. In recent years momentum has intensified among the various providers to coordinate capacity-building efforts aimed at helping to build debt management capacity in developing countries. Efforts to clearly understand the comparative advantage of each capacity-building provider compared with others have been made and partnerships strengthened. Furthermore, the international community has recognized the importance of public sector debt information and management as a global public good as well as its importance in the overall public financial management reform programmes of developing countries. A stronger global partnership framework in debt management capacity-building is nevertheless still needed. This includes coordinating efforts to ensure sustained financing from the international community for the continuation of the capacity-building efforts and tools on which the majority of developing countries are reliant.

53. Even with improved debt management and better and safer debt instruments, debt crises are bound to occur. Thus, the international community should not abandon the idea of creating a mechanism aimed at guaranteeing a speedy resolution of debt crises and a fair burden-sharing among creditors and debtors. For example, an independent international body could be mandated by both debtors and creditors to evaluate the debt situation of all countries faced with external debt problems and to propose the level and form of debt relief that needs to be provided.

Annex

External debt indicators

(Billions of United States dollars)

	All developing countries and countries with economies in transition						*Sub-Saharan Africa*					
	1990-94	*1995-98*	*1999-04*	*2005*	*2006*	*2007[a]*	*1990-94*	*1995-98*	*1999-04*	*2005*	*2006*	*2007[a]*
Total debt stocks	1 518.9	2 085.8	2 421.1	2 740.2	2 983.7	3 357.2	191.7	229.5	218.9	216.3	173.5	193.8
Long-term debt	1 234.1	1 665.1	1 969.8	2 128.6	2 305.3	2557.8	158.5	179.9	179.6	178.1	126.9	146.1
Private (share)	47.7	53.6	59.7	65.9	71.8	74.7	25.1	24.2	21.4	23.9	30.2	37.3
Private non-guaranteed (share)	8.3	20.1	28.6	35.8	45.0	47.8	4.1	5.4	5.7	4.8	7.3	13.7
Short-term debt	246.7	356.3	367.1	562.4	658.2	783.1	26.3	41.6	32.3	32.2	43.4	44.5
Debt service	155.6	263.5	383.2	506.7	573.4	523.0	10.0	15.0	12.8	20.1	21.4	16.8
International reserves	276.2	563.5	994.7	2 053.1	2 701.5	3 718.7	15.9	25.7	41.0	84.4	117.6	147.5
Arrears	123.5	128.5	113.4	105.7	112.8	106.5	40.2	60.5	44.0	39.3	41.7	36.5
Debt indicators (percentage)												
Debt service/exports	18.5	18.5	18.8	13.6	12.6	9.7	12.8	15.1	10.2	8.3	7.4	5.0
Total debt/exports	179.7	147.5	119.4	73.6	65.8	62.0	245.4	231.9	170.5	88.8	59.8	57.8
Debt service/gross national product	4.0	4.8	6.1	5.2	5.1	3.8	3.6	4.7	3.7	3.5	3.2	2.2
Total debt/gross national product	38.5	38.3	38.4	28.4	26.4	24.4	68.7	72.2	61.5	37.1	26.2	25.4
Reserves/short-term debt	110.4	158.2	263.6	365.1	410.4	474.9	62.7	61.7	129.2	262.0	270.6	331.8
Reserves/M2	14.2	19.5	21.2	28.9	31.5	34.7	14.9	21.0	26.8	30.9	35.1	33.1

	Middle East and North Africa						*Latin America and the Caribbean*					
	1990-94	*1995-98*	*1999-04*	*2005*	*2006*	*2007[a]*	*1990-94*	*1995-98*	*1999-04*	*2005*	*2006*	*2007[a]*
Total debt stocks	147.4	160.6	153.9	148.9	141.3	151.3	483.9	664.7	779.3	746.9	734.5	787.6
Long-term debt	122.9	138.5	130.4	124.6	116.5	125.6	375.4	519.4	650.5	625.2	627.5	651.9
Private (share)	34.5	26.4	30.1	39.6	42.0	44.2	64.5	73.0	78.2	78.7	80.6	82.1
Private non-guaranteed (share)	1.2	3.5	4.5	6.7	7.2	10.1	11.7	28.3	35.4	33.3	36.7	38.9
Short-term debt	22.7	19.5	21.2	23.7	24.4	25.3	93.0	122.6	98.4	108.5	106.2	135.0
Debt service	8.5	11.5	14.7	5.6	5.7	5.6	43.5	13.5	18.3	27.6	35.2	35.1
International reserves	18.8	19.7	19.0	21.7	29.9	20.1	51.8	110.1	155.7	161.5	194.8	146.0
Arrears	27.5	45.8	74.0	134.8	174.1	216.9	92.0	160.5	176.2	257.3	312.8	444.7
Debt indicators (percentage)												
Debt service/exports	20.1	18.1	12.5	8.7	10.4	6.1	25.0	31.8	33.8	22.8	23.0	15.3
Total debt/exports	157.6	148.6	101.1	59.8	49.1	45.9	235.2	193.8	169.0	105.4	86.8	82.5
Debt service/gross national product	8.2	6.1	4.6	3.8	4.6	2.6	4.1	5.8	8.5	6.6	6.9	4.4
Total debt/gross national product	64.0	49.5	37.5	26.2	21.9	19.5	38.8	35.3	42.7	30.6	25.8	23.7
Reserves/short-term debt	124.5	235.3	349.8	567.7	713.8	857.3	97.4	131.0	181.8	237.1	294.5	329.5
Reserves/M2	15.6	22.5	24.2	31.2	33.5	33.4	17.7	26.9	25.5	27.0	27.4	33.4

	East Asia and the Pacific						South Asia					
	1990-94	*1995-98*	*1999-04*	*2005*	*2006*	*2007[a]*	*1990-94*	*1995-98*	*1999-04*	*2005*	*2006*	*2007[a]*
Total debt stocks	300.5	502.4	533.2	614.1	660.0	715.6	138.1	152.2	171.2	191.3	227.3	240.3
Long-term debt	239.7	382.8	407.8	387.0	413.4	437.3	122.0	140.0	161.7	177.3	209.6	220.0
Private (share)	47.5	59.4	56.8	55.7	58.2	61.3	24.7	28.1	34.0	37.9	43.7	46.6
Private non-guaranteed (share)	15.6	31.4	33.5	34.3	38.3	41.6	2.7	7.3	12.8	19.9	39.4	27.9
Short-term debt	59.2	113.6	112.0	218.6	246.3	278.1	9.7	8.7	7.2	11.8	15.4	18.2
Debt service	8.4	14.2	18.3	24.7	24.7	24.5	0.1	0.5	0.3	0.1	0.2	0.0
International reserves	37.4	60.0	80.4	82.7	85.9	90.5	12.1	17.0	19.4	28.2	22.0	23.9
Arrears	96.9	213.2	447.5	1 020.4	1 315.7	1 856.8	18.2	33.5	84.2	156.7	198.5	277.3
Debt indicators (percentage)												
Debt service/exports	15.5	12.7	11.2	5.9	5.0	4.3	25.1	21.7	15.2	11.9	7.5	6.9
Total debt/exports	123.9	106.1	74.4	43.8	38.2	34.2	288.3	193.4	138.7	80.7	77.6	69.8
Debt service/gross national product	4.6	4.2	4.2	2.7	2.4	2.1	3.2	3.3	2.8	2.8	1.9	1.7
Total debt/gross national product	37.0	35.4	27.7	20.2	18.4	16.3	36.5	29.5	25.3	18.8	19.8	17.1
Reserves/short-term debt	167.6	195.5	395.7	466.7	534.1	667.6	229.6	397.2	1 133.3	1 325.7	1 286.2	1 520.6
Reserves/M2	14.0	15.0	16.7	26.3	28.3	32.7	10.1	13.3	19.6	23.0	24.8	26.8

	Europe and Central Asia					
	1990-94	*1995-98*	*1999-04*	*2005*	*2006*	*2007[a]*
Total debt stocks	257.3	376.4	564.8	822.7	1 047.0	1 268.5
Long-term debt	215.7	304.6	439.8	636.4	811.3	977.0
Private (share)	56.0	54.6	68.9	84.1	90.1	91.6
Private non-guaranteed (share)	4.3	14.0	36.3	58.1	67.7	70.9
Short-term debt	35.7	50.4	96.1	167.5	222.4	282.0
Debt service	22.8	28.4	17.8	8.4	5.3	4.8
International reserves	25.5	41.7	95.9	192.4	219.3	225.8
Arrears	25.9	84.9	171.8	399.6	582.8	786.1
Debt indicators (percentage)						
Debt service/exports	21.7	13.1	20.7	21.7	20.0	16.7
Total debt/exports	191.6	118.1	125.5	92.6	95.6	94.1
Debt service/gross national product	2.6	4.2	8.7	9.5	9.0	7.3
Total debt/gross national product	26.5	38.3	52.3	40.7	43.2	40.9
Reserves/short-term debt	74.1	172.4	173.2	238.6	262.0	278.8
Reserves/M2	11.8	28.3	37.4	45.2	51.3	49.8

Source: UNCTAD calculations based on World Bank, *Global Development Finance 2008* (online database) and "developing countries" as defined therein.

[a] Estimate.